Financial Audit of the Department of Business, Economic Development and Tourism

A Report to the Governor and the Legislature of the State of Hawaii

Report No. 03-03
March 2003

THE AUDITOR
STATE OF HAWAII

Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawaii State Constitution (Article VII, Section 10). The primary mission is to conduct post audits of the transactions, accounts, programs, and performance of public agencies. A supplemental mission is to conduct such other investigations and prepare such additional reports as may be directed by the Legislature.

Under its assigned missions, the office conducts the following types of examinations:

1. *Financial audits* attest to the fairness of the financial statements of agencies. They examine the adequacy of the financial records and accounting and internal controls, and they determine the legality and propriety of expenditures.

2. *Management audits*, which are also referred to as *performance audits*, examine the effectiveness of programs or the efficiency of agencies or both. These audits are also called *program audits*, when they focus on whether programs are attaining the objectives and results expected of them, and *operations audits*, when they examine how well agencies are organized and managed and how efficiently they acquire and utilize resources.

3. *Sunset evaluations* evaluate new professional and occupational licensing programs to determine whether the programs should be terminated, continued, or modified. These evaluations are conducted in accordance with criteria established by statute.

4. *Sunrise analyses* are similar to sunset evaluations, but they apply to proposed rather than existing regulatory programs. Before a new professional and occupational licensing program can be enacted, the statutes require that the measure be analyzed by the Office of the Auditor as to its probable effects.

5. *Health insurance analyses* examine bills that propose to mandate certain health insurance benefits. Such bills cannot be enacted unless they are referred to the Office of the Auditor for an assessment of the social and financial impact of the proposed measure.

6. *Analyses of proposed special funds* and existing *trust and revolving funds* determine if proposals to establish these funds are existing funds meet legislative criteria.

7. *Procurement compliance audits* and other *procurement-related monitoring* assist the Legislature in overseeing government procurement practices.

8. *Fiscal accountability reports* analyze expenditures by the state Department of Education in various areas.

9. *Special studies* respond to requests from both houses of the Legislature. The studies usually address specific problems for which the Legislature is seeking solutions.

Hawaii's laws provide the Auditor with broad powers to examine all books, records, files, papers, and documents and all financial affairs of every agency. The Auditor also has the authority to summon persons to produce records and to question persons under oath. However, the Office of the Auditor exercises no control function, and its authority is limited to reviewing, evaluating, and reporting on its findings and recommendations to the Legislature and the Governor.

THE AUDITOR
STATE OF HAWAII
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OVERVIEW

Financial Audit of the Department of Business, Economic Development and Tourism

Report No. 03-03, March 2003

Summary

The Office of the Auditor and the certified public accounting firm of KPMG LLP conducted a financial audit of the Department of Business, Economic Development and Tourism, State of Hawaii, for the fiscal year July 1, 2001 to June 30, 2002. The audit examined the financial records and transactions of the department; reviewed the related systems of accounting and internal controls; and tested transactions, systems, and procedures for compliance with laws and regulations.

We found deficiencies in the financial accounting and internal control practices of the department. We found that the department is deficient in the management of its loan programs. The department administers four revolving loan programs that were developed to stimulate Hawaii's economy and be responsive and beneficial to small businesses unable to obtain financing through the private sector.

However, we found that the department issued only 16 loans totaling $2,333,500 during the five-year period ended June 30, 2002. In addition, of the 94 outstanding loans with an aggregate principal balance of $9,449,566, 45 loans (48 percent) with an aggregate principal balance of $5,568,059 (59 percent) were greater than 90 days past due.

Although the department has policies and procedures in place to administer its various loan programs, these policies and procedures are neither formally documented nor consistently enforced. The department does not actively monitor its delinquent loans or its delinquent participation loans.

We found that the department's loan files are incomplete. Loan files selected for review were missing adequate documentation of on-site inspections of applicants' collateral or evidence that loan proceeds were spent for authorized purposes. The department is not consistently using the informal checklist that it developed to assist in assuring that all necessary documents are obtained and maintained in the loan files.

We also found that 12 loan repayment checks out of a sample of 15 (80 percent), were not deposited by the department in a timely manner. The checks totaled $226,171 and averaged six elapsed business days between their receipt and deposit.

The Hawaii Tourism Authority does not adequately manage its contracts. We found that contractors performed services prior to the execution of legally binding contracts; contracts were renewed prior to the authority's evaluation of the quality of the work provided; and, in one instance, final payment was remitted to the contractor prior to completion of all required tasks.

We found that the department does not properly lapse unnecessary encumbrances. Our testing found 11 instances, out of a sample of 30, where funds remained encumbered for contracts or purchase orders that were canceled, inactive, and/or expired. Of the 11 instances, eight encumbrances totaling $517,430 should have been voided at least two fiscal years ago, with one encumbrance that should have been voided in 1994. The department's failure to identify and lapse invalid encumbrances has denied the State its opportunity to utilize these funds for other priorities.

The department must improve the administration of its petty cash funds. Petty cash functions are inadequately segregated; the petty cash custodian performs both custodial and reconciliatory functions. Also, the department's various divisions do not submit account reconciliations to the fiscal office in a timely and consistent manner. We found that seven out of a sample of 15 petty cash replenishment requests were not accompanied by reconciliations as required by department policy.

Finally, the balance of $25,000 maintained in the department's administration petty cash fund is excessive. The average monthly disbursement out of the account during FY2001-02 was $356, and $776 was the largest monthly disbursement. Once again, the State is denied the opportunity to utilize the funds for other priorities.

Recommendations and Response

We recommend that the department increase participation in its loan programs and implement a formal marketing strategy. Also, the department should revise its procedures for monitoring delinquent accounts and contact borrowers as soon as their accounts become ten days past due.

We also recommend that the department establish written guidelines for loan functions, properly maintain loan files and ensure that the files contain all required documentation, and deposit loan repayments on the day of receipt.

The Hawaii Tourism Authority should execute formal contracts before contractors perform services, monitor contracts and relevant agreement terms in a complete and timely manner, ensure receipt of final reports from contractors by the stipulated completion date, withhold final payments from contractors until final reports are received and approved, and perform final evaluations of each contractor prior to entering into any subsequent agreements with them.

In addition, we recommend that the department unencumber funds relating to contracts/purchase orders that are fulfilled during the year; ensure that all encumbrances correspond to active and ongoing projects or purposes; and promptly unencumber existing encumbrances related to closed, terminated, and/or completed projects or purposes.

Finally, the department should assess the segregation of duties related to the department's various petty cash funds, perform periodic and unannounced reviews of each division's petty cash account reconciliations and cash counts, require divisions to prepare and submit reconciliations of petty cash accounts in adherence to established policies, and significantly reduce the amount of funds in the administration petty cash fund.

The department agrees with some of our findings and recommendations and noted that it has already begun to implement some of our recommendations.

The Hawaii Tourism Authority, although not in complete agreement with our findings, stated that it will insist upon strict compliance with its technical contract management requirements by it contractors.

Marion M. Higa
State Auditor
State of Hawaii

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Financial Audit of the Department of Business, Economic Development and Tourism

A Report to the Governor and the Legislature of the State of Hawaii

Conducted by

The Auditor
State of Hawaii
and
KPMG LLP

Submitted by

THE AUDITOR
STATE OF HAWAII

Report No. 03-03
March 2003

Foreword

This is a report of the financial audit of the Department of Business, Economic Development and Tourism, State of Hawaii, for the fiscal year July 1, 2001 to June 30, 2002. The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the State Auditor to conduct postaudits of all departments, offices, and agencies of the State and its political subdivisions. The audit was conducted by the Office of the Auditor and the certified public accounting firm of KPMG LLP.

We wish to express our appreciation for the cooperation and assistance extended by officials and staff of the Department of Business, Economic Development and Tourism.

Marion M. Higa
State Auditor

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List of Exhibits

Chapter 1
Introduction

This is a report of our financial audit of the Department of Business, Economic Development and Tourism, State of Hawaii (department). The audit was conducted by the Office of the Auditor and the independent certified public accounting firm of KPMG LLP. The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes (HRS), which requires the State Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State of Hawaii (State) and its political subdivisions.

Background

Section 26-18, HRS, describes the department's responsibilities. It states that "The department shall undertake statewide business and economic development activities, undertake energy development and management, provide economic research and analysis, plan for the use of Hawaii's ocean resources, and encourage the development and promotion of industry and international commerce through programs established by law."

Organization

The director plans, organizes, directs, coordinates, and reports on the various activities of the department. The director is supported by three offices, five divisions, and 12 administratively attached bodies. Exhibit 1.1 displays the department's organizational structure. The primary responsibilities of these units follow.

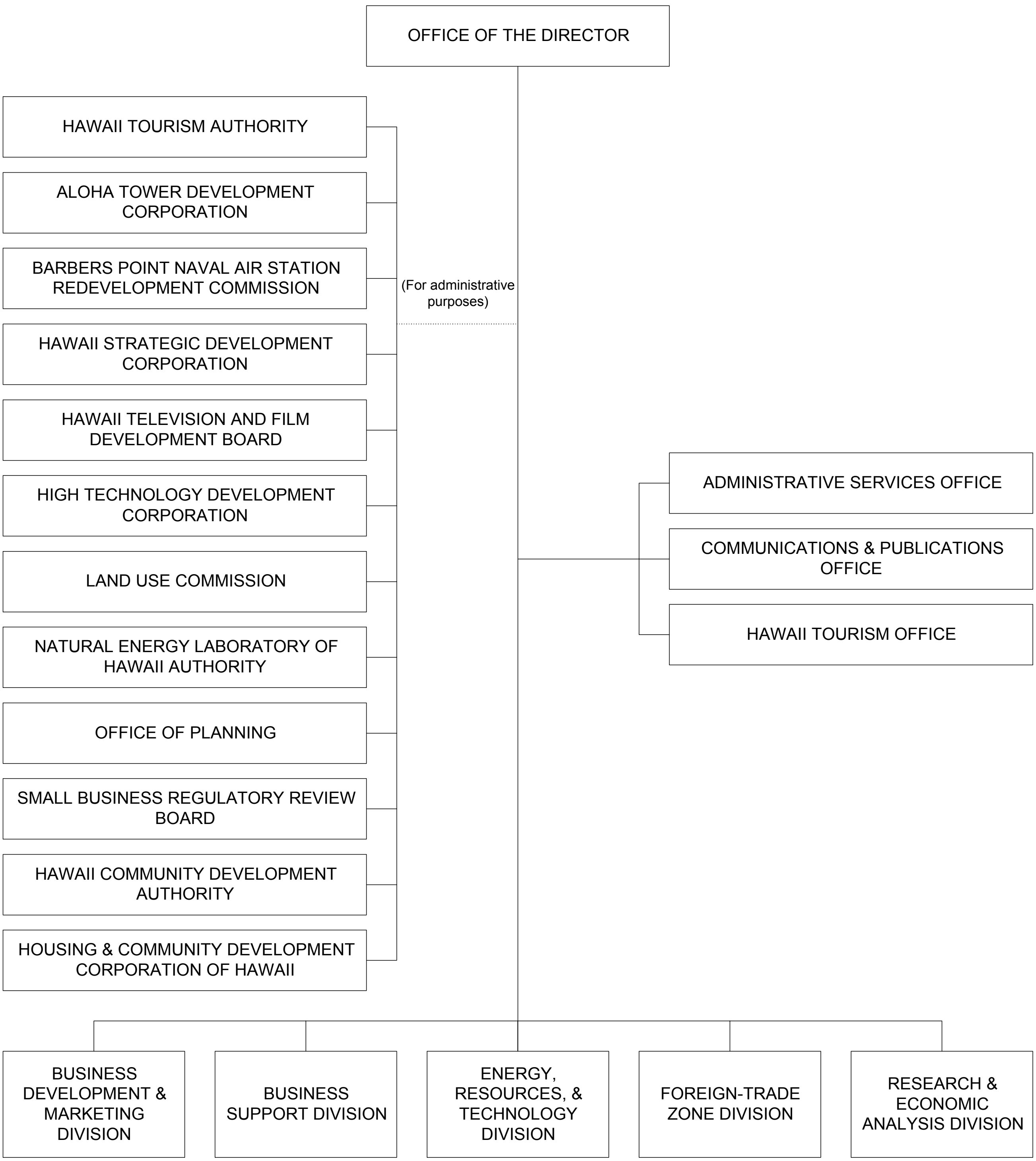
Staff offices

The Administrative Services Office provides general internal management, fiscal, budgetary, contractual, and personnel services in support of departmental programs and activities; it also provides advice and assistance to the director and staff in administrative matters.

The Communications and Publications Office serves as the central communications, publishing, marketing, and public relations arm of the department for the widespread dissemination of information on business, investment, and economic opportunities and conditions in the State.

The Hawaii Tourism Office has been inactive since July 1, 1998 and was abolished by the Legislature on July 1, 2002.

Exhibit 1.1
Organizational Structure of the Department of Business, Economic Development and Tourism



Source: Department of Business, Economic Development and Tourism.

Operating divisions

The Business Development and Marketing Division promotes the stability, growth, and diversification of commerce and industry in Hawaii through planning, organizing, and implementing activities, projects, and programs to attract selected industries to Hawaii. It encourages local industries to grow and prosper; develops domestic and international markets for Hawaii's products and services; provides the department's international protocol needs; administers Hawaii's sister-state relationships; encourages investment in Hawaii; promotes Hawaii as a good place to do business; and creates more skilled, rewarding jobs in Hawaii.

The Business Support Division facilitates the formation and growth of small business by providing financial, managerial, technical, and other assistance to new and existing businesses; provides information services; administers state and local government activities partially funded under the U.S. Economic Development Administration; administers statutes providing for the creation of Enterprise Zones; and provides assistance to small businesses in obtaining orders from government for goods and services.

The Energy, Resources, and Technology Division supports statewide economic efficiency, productivity, development, and diversification by promoting, attracting, and facilitating the development of Hawaii-based industries that engage in the sustainable development of Hawaii's energy, environmental, ocean, recyclable, remanufacturing, and technological resources.

The Foreign-Trade Zone Division establishes, operates, and maintains a foreign-trade program; promotes international trade throughout Hawaii; encourages establishment of new industry and employment; expands export markets for Hawaii's businesses; and diversifies the industrial base through establishment of neighbor island sub-zones and general purpose zone expansion sites.

The Research and Economic Analysis Division enables sound public and private decisions by providing timely data, information, and analysis of economic, demographic, and related issues affecting Hawaii's people, consistent with statewide program objectives.

Administratively attached bodies

The Hawaii Tourism Authority develops a strategic tourism marketing plan and measures of effectiveness to assess the overall benefits and effectiveness of the marketing plan as it relates to the State's tourism industry. A 13-member board heads the authority.

The Aloha Tower Development Corporation oversees redevelopment of the Aloha Tower complex to strengthen the international economic base of the community in trade activities, enhance beautification of the waterfront and, in conjunction with the state Department of Transportation, better serve modern maritime uses; and provides for public access and use of the waterfront property. A seven-member board directs the corporation.

The Barbers Point Naval Air Station Redevelopment Commission facilitates redevelopment of Barbers Point Naval Air Station in accordance with the Barbers Point Naval Air Station community reuse plan. Fifteen members comprise the commission.

The Hawaii Strategic Development Corporation encourages economic development and diversification in Hawaii through innovative actions in cooperation with private enterprises. An 11-member board governs the corporation.

The Hawaii Television and Film Development Board administers grant and venture capital investment programs and the Hawaii Television and Film Development Special Fund. Nine members comprise the board.

The High Technology Development Corporation facilitates the growth and development of Hawaii's commercial high technology industry. An 11-member board governs the corporation.

The Land Use Commission preserves, protects, and encourages development of lands in Hawaii for those uses to which they are best suited. Nine members comprise the commission.

The Natural Energy Laboratory of Hawaii Authority facilitates research, development, and commercialization of natural energy resources and ocean-related research, technology, and industry in Hawaii. It engages in retail, commercial, and tourism activities that financially support such research, development, and commercialization at a research and technology park on Hawaii. An 11-member board governs the authority.

The Office of Planning gathers, analyzes, and provides the governor with information to assist in the overall analysis and formulation of state policies and strategies; provides central direction and cohesion in the allocation of resources and effectuation of state activities and programs; and effectively addresses current or emerging issues and opportunities.

The Small Business Regulatory Review Board considers requests from small business owners for review of any rule adopted by a state agency and makes recommendations to the agency or the Legislature regarding the need for a rule change or legislation. The board consists of 11 members.

The department also has the following two administratively attached bodies that are not included within the report's scope.

The Hawaii Community Development Authority provides long-range planning and implementation for improved community development in those urban areas designated as Community Development Districts by the Legislature. An 11-member board heads the authority.

The Housing and Community Development Corporation of Hawaii manages federal and state low-rent public housing projects and subsidy programs, as well as facilities to assist the homeless; administers housing finance and development programs to assist low and moderate-income renters and first-time homebuyers; and finances affordable rental housing projects. A nine-member board heads the corporation.

Objectives of the Audit

1. To assess the adequacy, effectiveness, and efficiency of the systems and procedures for the financial accounting, internal control, and financial reporting of the department; to recommend improvements to such systems, procedures, and reports; and to report on the fairness of the financial statements of the department.

2. To ascertain whether expenses/expenditures or deductions and other disbursements have been made and all revenues or additions and other receipts have been collected and accounted for in accordance with federal and state laws, rules and regulations, and policies and procedures.

3. To make recommendations as appropriate.

Scope and Methodology

We audited the financial records and transactions and reviewed the related systems of accounting and internal controls of the department for the fiscal year July 1, 2001 to June 30, 2002. We tested financial data to provide a basis to report on the fairness of the basic financial statements' presentation. We also reviewed the department's transactions, systems, and procedures for compliance with applicable laws, regulations, and contracts.

We examined the department's accounting, reporting, and internal control structure and identified deficiencies and weaknesses therein. We made recommendations for appropriate improvements including, but not limited to, the department's forms and records, management information system, and accounting and operating procedures.

The independent auditors' opinion as to the fairness of the department's basic financial statements presented in Chapter 3 is that of KPMG LLP. The audit was conducted from July 2002 through November 2002 in accordance with auditing standards generally accepted in the United States of America as set forth by the American Institute of Certified Public Accountants and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Chapter 2

Internal Control Deficiencies

Internal controls are steps instituted by management to ensure that objectives are met and resources safeguarded. This chapter presents our findings and recommendations on the financial accounting and internal control practices and procedures of the Department of Business, Economic Development and Tourism (department).

Summary of Findings

We found several reportable conditions involving the department's internal control over financial reporting and operations. Reportable conditions are significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the department's ability to record, process, summarize, or report financial data consistent with the assertions of management in its financial statements.

We found the following reportable conditions:

1. Deficiencies in the department's management of its loan programs have hindered attainment of its objective of stimulating the economy by providing financial assistance to small businesses. The department has initiated only a limited number of loans during the past few years. In addition, poor monitoring has led to a significant volume of delinquent loans and write-offs; and the department's policies and procedures over its loan functions are not formally documented or consistently enforced. This has resulted in inconsistencies in the department's maintenance of loan files and processing of loan repayments.

2. The Hawaii Tourism Authority has not adequately managed its contracts. We found that services were performed by contractors prior to execution of legally binding contracts; final reports from contractors were not received in a timely manner; contracts were renewed prior to the authority's evaluation of work provided; and, in one instance, the final contractor payment was dated prior to completion of all required tasks.

3. The department lacks formal policies and procedures over the identification and lapsing of invalid fund reservations. This has resulted in numerous outstanding encumbrances relating to projects and/or purposes that were canceled, expired, and/or completed. The

department's failure to identify and lapse invalid encumbrances has denied the State its opportunity to utilize these funds for other priorities.

4. The department's administration of petty cash funds must be improved to minimize the risk of misuse or misappropriation. Duties are not adequately segregated, and reconciliation of petty cash accounts are not performed in a timely and consistent manner. In addition, excessive cash is maintained in the department's administration petty cash fund, which is not earning interest.

The Department's Management of Its Loan Programs Is Ineffective

The objectives of the department's Business Support Division are to:

> …support new and existing businesses through direct loans; licensing and permit information and referral; business advocacy; planning and coordination of programs and projects aimed at specific business sectors or economically-distressed areas, including rural areas and areas affected by natural disaster; and to promote the statewide economic development of the film and video industry in Hawaii.

As a means of accomplishing these goals, the department administers the following four revolving loan programs through its Business Support Division:

1. Hawaii Disaster Commercial and Personal Loan Program,
2. Hawaii Capital Loan Program,
3. Community-Based Economic Development Program, and
4. Hawaii Innovation Development Program.

These loan programs were developed with the intent to stimulate Hawaii's economy and to be responsive and beneficial to small businesses unable to obtain financing through the private sector. However, deficiencies in the department's management of its loan programs have hindered the department's ability to fulfill these objectives. We found very few loans were originated by the department in the past few years, and formal policies and procedures over various loan functions were lacking. Additionally, the department is deficient in monitoring its outstanding loans, resulting in a significant number of delinquent loans and write-offs.

The department has originated only a limited number of loans over the past few years

Despite sufficient funding, the department has issued only 16 loans totaling $2,333,500 during the five-year period ended June 30, 2002. The volume of loans issued and available cash balances for each of the past five fiscal years are as follows:

	FY2001-02	FY2000-01	FY1999-2000	FY1998-99	FY1997-98
No. of loans issued	10	0	4	1	1
Amount of loans issued	$420,000	--	$808,500	$725,000	$380,000
Available cash	$6,729,269	$8,237,184	$11,031,084	$10,392,939	$10,584,436

Of the available cash balances as of June 30, 2002, the Department of Accounting and General Services has notified the department that $2,450,000 will revert back to the general fund during the fiscal year ending June 30, 2003.

The primary reason for the limited number of loans being issued is the department's decision to place top priority on high technology and biotechnology loans. The loan officer informed us that the department turned away several loan applicants because they were not involved in high technology or biotechnology. This internal policy of narrowing the focus of its loan programs has hampered the department's ability to provide new loans and meet its objective of supporting new and existing small businesses in Hawaii. Department personnel also indicated that the limited number of loans issued was due in part to fewer applications stemming from potential borrowers' fear of incurring additional debt during a depressed local economy.

Another reason for the low loan issuance rate is the department's insufficient marketing of its loan programs. The department promotes its various loan programs at conferences, bankers' organizations, and financial panels throughout the year. However, the department does not have a formal marketing strategy in place to increase public awareness of its loan programs and does not have informational materials (e.g., pamphlets, brochures, flyers) available for potential applicants. A formal marketing strategy would enhance the department's ability to generate new loans and fulfill its objective of supporting small businesses.

Deficiencies in the department's monitoring of loans have led to a significant volume of delinquent loans and write-offs

The department's policies and procedures for monitoring outstanding loans and identifying past due accounts are deficient. The department neither follows up with delinquent borrowers in a timely manner nor monitors its delinquent participation loans with other financial institutions.

Failure to adequately identify and monitor delinquent accounts has hindered the department's collection efforts and resulted in a significant amount of past due balances and loan write-offs. At June 30, 2002, the department had 94 outstanding loans with an aggregate principal balance of $9,449,566. Of these loans, 45 loans—with an aggregate principal balance of $5,568,059—were greater than 90 days past due. Loan amounts written off by the department in FY2001-02 and FY2000-01 amounted to $281,418 and $734,966, respectively.

The following table illustrates the total number of loans greater than 90 days past due, the total principal amount of loans greater than 90 days past due, and the total amount of loans written off during the previous three fiscal years:

	FY2001-02	FY2000-01	FY1999-2000
No. of loans outstanding at June 30	94	96	106
No. of loans with balances >90 days past due at June 30	45	49	53
Percent of loans >90 days past due at June 30	48%	51%	50%
Amount of loans outstanding at June 30	$9,449,566	$9,971,277	$12,107,292
Amount of loans with balances >90 days past due at June 30	$5,568,059	$5,931,910	$6,611,252
Percent of loans >90 days past due at June 30	59%	59%	55%
No. of loans written off as of June 30	6	4	5
Amount of loans written off as of June 30	$281,418	$734,966	$6,824

To assist in monitoring delinquent loans, the department generates a monthly *Contractual Delinquency Report* and a quarterly *Non-Tax Revenue Collection Report — Accounts Over 60 Days Report*. Both reports are reviewed by the department and used to identify and monitor delinquent borrowers. We found that these reports were not generated on a timely basis. Consequently, the department has been unable to identify delinquent accounts until after they were 30 days past due. Waiting until accounts are 30 days past due does not enable the department to work proactively with delinquent borrowers to develop effective repayment plans. In comparison, financial institutions generate daily delinquency reports and contact delinquent borrowers the moment a loan becomes past due.

We also found that the department does not actively monitor its delinquent participation loans. Participation loans are loans in which the department assists other financial institutions (lead banks) in providing funds to borrowers. For these types of loans, the department's policy is to contact the lead bank once an account is more than 30 days past due. However, the department's loan officer informed us that no subsequent correspondence is made to ensure the lead bank adequately monitors the delinquent borrower. Because the department has not been actively working with its various lead banks, the department is unable to determine the sufficiency of collection efforts made.

The department lacks formal policies and procedures for its various loan functions

Although the department has policies and procedures in place to administer its various loan programs, these policies and procedures are neither formally documented nor consistently enforced. The department lacks formal written guidelines over loan origination, maintenance of loan files, loan payment processing, and monitoring of delinquent borrowers. Formally documenting and enforcing established policies and procedures is necessary to ensure that loans are approved and serviced consistently and according to departmental guidelines. Failure to adequately document and enforce its policies and procedures has resulted in inconsistencies in the department's maintenance of loan files and the processing of loan repayments.

The department's loan files are incomplete

Loan files contain vital documentation for each loan and should provide evidence that the department's policies and procedures are followed. Our review of selected loan files revealed that they did not contain adequate documentation of on-site inspections of applicants' collateral or evidence that loan proceeds were spent for authorized purposes.

Collateral may be defined as property that secures a loan or other debt, such that a lender may seize it if a borrower fails to make proper payments on a loan. Lenders require collateral to secure loans in order to minimize their risk when extending credit. To ensure that particular collateral provides appropriate security, lenders generally match the type of collateral with the loan being made. On-site inspections of such collateral are necessary to verify its existence and ensure that it is adequate and in the condition described in the loan documents.

The department's loan officer indicated that on-site inspection of the applicant's collateral by a business loan officer should be completed prior to a loan's formal approval. However, documentation of this on-site inspection is not consistently maintained in loan files. We were unable to locate proof of on-site inspections for any of the 28 loan files we reviewed. As a result, we were unable to verify that these required, on-site inspections were properly performed. Failure to inspect and verify collateral could result in inadequate security on outstanding loans.

All borrowers should also provide the department with evidence that their loan proceeds were spent for authorized purposes. However, we found that eight out of a sample of 24 borrowers (30 percent) did not submit receipts and/or supporting documentation to the department evidencing proper use of their loan proceeds. As a result, we were unable to verify that loan proceeds were spent for authorized purposes in these cases. The original amount of the eight loans totaled $1,206,000.

The department has developed an informal checklist of required loan file documentation to assist in assuring that all necessary documents are obtained and filed. However, the department's loan officer indicated that the checklist is not consistently used; as a result, loan files contain inadequate documentation. This in turn may limit the department's recourse on defaulted loans—the department could find itself unable to prevail in any action taken against a defaulting loan recipient because of insufficient documentation.

Loan repayments were not deposited on a timely and consistent basis

Checks received by the department for loan repayments should be deposited on the day of receipt. Delays in depositing loan repayment checks result in lost interest earnings to the department and increase the possibility of checks being lost or misappropriated.

Out of a sample of 15 loan repayment checks, we found 12 (80 percent) that were not deposited by the department on a timely basis. These checks totaled $226,171, and the average number of business days elapsed between their receipt and deposit was six business days. Checks amounting to $83,325 and $29,500 were deposited six and nine business days, respectively, after they were received.

Recommendations

We recommend that the department:

- Reconsider its decision to place top priority on loans issued to high technology and biotechnology businesses in order to increase participation in the department's loan programs by small businesses in Hawaii;
- Implement a formal marketing strategy to increase public awareness of its various loan programs. These efforts could include preparing informational packets for distribution to loan officers at various financial institutions in Hawaii. Loan officers could then provide the informational packets to loan applicants who are initially denied credit by the financial institution but may qualify for the department's various loan programs;
- Revise procedures to monitor delinquent accounts by contacting borrowers as soon as their accounts become ten days past due. For participation loans, the department should coordinate collection efforts with lead financial institutions to ensure collection of past due amounts;

- Establish written guidelines for the following loan functions: loan origination, maintenance of loan files, loan payment processing, and monitoring of delinquent borrowers;
- Ensure that loan files are properly maintained and contain all required documentation. The department's standardized checklist of all required loan file documentation should be consistently utilized to ensure proper file maintenance; and
- Deposit loan repayments on the day of receipt.

The Hawaii Tourism Authority Does Not Adequately Manage Its Contracts

Third-party contractors perform a significant portion of the Hawaii Tourism Authority's functions. The authority's contractors assist in coordinating events to be held in Hawaii and assist in marketing and promoting Hawaii as a vacation and business destination. During the fiscal year ended June 30, 2002, the authority incurred approximately $69.4 million in contract expenditures, which accounted for over 98 percent of its total expenditures.

Upon completion of each contract, all contractors hired by the Hawaii Tourism Authority are required to complete and submit a final report documenting the scope of work performed, costs incurred, reasons for any deviations from the terms and conditions of the contract, anticipated benefits, areas for which improvement is needed, and any other additional comments and/or suggestions noted while performing the service. The authority is supposed to review and approve all final reports to ensure that services were performed according to the contract's terms and to determine whether the authority should continue to do business with the respective contractor. The authority's policy is to withhold final payment until the contractor submits a final report, and the authority approves it.

Despite these requirements, we found that contractors performed services prior to the execution of legally binding contracts; contractors' final reports were not received in a timely manner; contracts were renewed prior to the authority's evaluation of the quality of the work provided; and, in one instance, final payment was remitted to the contractor prior to completion of all required tasks.

We reviewed a total of 16 contracts, accounting for more than 70 percent of the authority's current year's contract expenditures and found:

- Three instances where contractors commenced work prior to the execution of legally binding contracts. These contracts totaled $233,000, with contractors performing services as early as eight months prior to the contract's formal execution;

- Three instances where the authority received and approved final reports after the deadline specified in the contract agreement. These contracts totaled $475,000. The authority received the final reports as long as 11 months after the deadline specified in the contract;

- Two instances where the authority renewed contracts prior to the final reports' receipt and approval. These contracts totaled $150,000 and were renewed as early as seven months prior to receipt of final reports; and

- One instance where the authority dated a contractor's payment prior to the final reports' receipt and approval. The contract totaled $100,000, and the final payment of $40,000 was made approximately one month before the final report was approved.

Properly executed contracts ensure that the type and scope of services agreed upon and the roles and responsibilities of both the authority and its contractors are clearly delineated, avoiding confusion or misunderstanding. Contracts should be properly executed before any services are rendered. Without the benefit of a contract, there is no assurance that services provided are those required. Additionally, providing services without contractually defined roles and responsibilities places the authority in jeopardy should any legal problems arise.

Given the magnitude of service contracts and the authority's limited resources, it is imperative the authority monitor contractors and relevant agreement terms in a complete and timely manner. This includes evaluation of contractor performance and required deliverables prior to final payment and contract renewals, as well as ensuring that final reports are received from contractors by the completion date stipulated in the contract.

Recommendations

We recommend that the Hawaii Tourism Authority:

- Execute formal contracts before contractors perform services;

- Monitor contracts and relevant agreement terms in a complete and timely manner. Final reports should be received from contractors by the completion date stipulated in the contract. Further, final payments should be withheld from contractors until final reports are received and approved; and

- Perform final evaluations of each contractor prior to entering into any subsequent agreements with them.

The Department's Failure to Lapse Unnecessary Encumbrances Has Deprived the State of the Use of Funds for Other Priorities

Encumbrances are obligations of the department in the form of purchase orders, contracts, or other such commitments that do not become liabilities until the conditions stated in the commitment are incurred. The primary purpose for encumbering funds is to reserve an appropriation (or portions thereof) to cover outstanding obligations or commitments. All outstanding encumbrances related to projects or purposes that have been closed, terminated, and/or completed should be promptly unencumbered, and unspent funds should be made available for other state purposes.

To budget and allocate state funds properly, the Legislature requires an accurate accounting of available funds. By not lapsing old, unnecessary encumbrances, the department has understated its unreserved fund balance. As a result, funds improperly reserved by the department are not available to other programs and departments. This occurs primarily because the department does not adhere to its policies for unencumbering funds, and it does not have a process in place to monitor outstanding encumbrances.

The department does not properly unencumber funds

We found numerous encumbrances outstanding at June 30, 2002 that related to inactive contracts and purchase orders. We found 11 instances out of a sample of 30 where funds were encumbered for contracts or purchase orders that were canceled, inactive, and/or expired. Of the 11 instances, eight related to encumbrances that should have been voided at least two fiscal years ago, with one encumbrance that should have been voided in 1994. These eight encumbrances ranged from $7,282 to $190,000 and totaled $517,430.

Department personnel indicated that invalid encumbrances exist because of a lack of communication between the divisions and the fiscal office. The division that originates a contract/purchase order is responsible for informing the fiscal office when the contract/purchase order is no longer active and/or no further payments are expected. Upon such notification, the fiscal office is responsible for unencumbering any unspent balances relating to the contract/purchase order. Department personnel indicated that in all of the instances previously noted, the originating division failed to inform the fiscal office that the contract/purchase order was no longer active. Because the fiscal office was not aware that the contract/purchase order was inactive, the fiscal office failed to unencumber the remaining unspent balances.

The department's inability to monitor outstanding encumbrances has led to a significant accumulation of invalid encumbrances

The department lacks a formal process to ensure the validity of fiscal year-end encumbrances. As a result, numerous unspent balances have remained encumbered despite the fact that the contracts/purchase orders they relate to are no longer active. Based on an evaluation of all encumbrances outstanding at June 30, 2002 greater than five years old, we identified 40 encumbrances totaling $879,385 ($312,640 in the capital projects fund, $538,929 in the general fund, and $27,816 in the economic development special revenue fund) that related to commitments that were canceled, terminated, and/or completed.

The fiscal office should periodically perform an in-depth review of all outstanding encumbrances to ensure that all items relate to future expenditures the department will be required to pay. While performing this review, particular attention should be paid to old encumbrances (e.g., those which have been outstanding for more than two years). All outstanding encumbrances relating to inactive or closed contracts or purchase orders should be properly unencumbered. Departmental personnel informed us they do not annually review outstanding encumbrances to verify that all encumbered amounts are for valid future expenditures. Departmental personnel also informed us they do not investigate old encumbrances to ensure that encumbered amounts relate only to active projects.

Recommendations

We recommend that the department:

- Adhere to established policies and procedures to unencumber funds relating to contracts/purchase orders that are fulfilled during the year;

- Periodically evaluate the propriety of all outstanding encumbrances. Ensure that all encumbrances correspond to active and ongoing projects or purposes; and

- Promptly unencumber encumbrances related to closed, terminated, and/or completed projects or purposes.

The Department's Administration of Petty Cash Funds Must Be Improved

The department maintains petty cash balances at 15 divisions totaling $57,050. These funds are used for small purchases and employee reimbursements less than $100. Disbursements from the petty cash funds must be supported by original receipts and approved by both the petty cash custodian and respective division head. Petty cash funds are generally replenished on a monthly basis or as necessary. At any given time, petty cash on hand plus outstanding petty cash vouchers should equal the original amount of the petty cash fund. Petty cash account balances are authorized based on the respective program's needs. We found that the department lacks adequate controls over petty cash, and an excessive amount of cash is maintained in one of its petty cash accounts that does not earn interest income for the State.

Internal controls over petty cash are inadequate

The department lacks adequate segregation of duties over petty cash functions, and reconciliations of petty cash accounts are not performed in a timely and consistent manner. The petty cash custodian performs both custodial and reconciliation functions, which should be separated and performed by different individuals to minimize the risk of misappropriation of petty cash funds. Given the limited resources at each division, it may be more feasible to have an individual independent of the petty cash fund perform periodic, unannounced reviews of petty cash reconciliations including unannounced cash counts.

In addition to the lack of segregation of duties, the department's various divisions do not submit account reconciliations to the fiscal office in a timely and consistent manner as required by department policy. Upon each replenishment request, all divisions must submit to the fiscal office reconciliations of their petty cash funds. However, department personnel informed us that the fiscal office has not been enforcing this requirement. As a result, we found seven reimbursement requests out of a sample of 15 that were received and processed by the fiscal office without a completed reconciliation of the respective division's petty cash account. At June 30, 2002, we noted an overage in the Foreign Trade Zone's petty cash account; all other petty cash balances were properly reconciled.

Excessive cash is maintained in the department's administration fund, which does not earn interest

The department maintains a balance of $25,000 in its administration petty cash fund. During fiscal year ended June 30, 2002, the average monthly disbursement out of this account was $356; $776 was the largest monthly disbursement. Replenishment requests are generally prepared monthly, and the department receives replenishments approximately five weeks after requests are submitted.

Based on the account's minimal monthly disbursements and the frequency with which the fund is replenished, the $25,000 balance is excessive and the majority of this balance should be returned to the general fund. Also, these excess funds do not earn interest.

Recommendations

We recommend that the department:

- Perform periodic, unannounced reviews of each division's petty cash account reconciliations, including unannounced cash counts. An employee independent of the petty cash process should perform the review;
- Adhere to established policies requiring divisions to prepare and submit reconciliations of their petty cash account upon each request for replenishment. If reconciliations are not prepared and submitted, the fiscal office should not process the replenishment request; and
- Significantly reduce the amount of funds in the administration petty cash fund.

Chapter 3

Financial Audit

This chapter presents the results of the financial audit of the Department of Business, Economic Development and Tourism (department) as of and for the fiscal year ended June 30, 2002. This chapter includes the independent auditors' report and the report on compliance and internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards*. It also displays the basic financial statements of the department together with explanatory notes.

Summary of Findings

In the opinion of KPMG LLP, based on their audit, the basic financial statements present fairly, in all material respects, the financial position of the department as of June 30, 2002, and the changes in its financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America. KPMG LLP noted matters involving the department's internal control over financial reporting and its operations that the firm considered to be reportable conditions. KPMG LLP also noted that the results of its tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Independent Auditors' Report

The Auditor
State of Hawaii:

We have audited the accompanying financial statements of the governmental activities and each major fund of the Department of Business, Economic Development and Tourism, State of Hawaii (department), as of and for the year ended June 30, 2002, which collectively comprise the department's basic financial statements. These financial statements are the responsibility of the department's management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

As discussed in Note 1, the financial statements of the department are intended to present the financial position and the changes in financial position of only that portion of the governmental activities and major fund information of the State that are attributable to the transactions of the department. They do not purport to, and do not, present fairly the financial position of the State of Hawaii as of June 30, 2002, and the changes in its financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and each major fund of the department as of June 30, 2002, and the respective changes in financial position and the respective budgetary comparison for the general and economic development special revenue funds for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As described in Note 1 to the basic financial statements, the department adopted Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*; GASB Statement No. 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus*; GASB Statement No. 38, *Certain Financial Statement Note Disclosures*; and Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*, effective July 1, 2001.

In accordance with *Government Auditing Standards*, we have also issued a report dated November 8, 2002 on our consideration of the department's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The department has not presented management's discussion and analysis that accounting principles generally accepted in the United States of America has determined is necessary to supplement, although not required to be part of, the basic financial statements.

/s/ KPMG LLP

Honolulu, Hawaii
November 8, 2002

Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

The Auditor
State of Hawaii:

We have audited the basic financial statements of the Department of Business, Economic Development and Tourism, State of Hawaii (department), as of and for the year ended June 30, 2002, and have issued our report thereon dated November 8, 2002. The department adopted Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*; GASB Statement No. 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus*; GASB Statement No. 38, *Certain Financial Statement Note Disclosures*; and Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*, effective July 1, 2001. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

Compliance
As part of obtaining reasonable assurance about whether the department's basic financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, including applicable provisions of the Hawaii Public Procurement Code (Chapter 103D, Hawaii Revised Statutes) and procurement rules,

directives, and circulars, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards* and which we have reported to the Auditor, State of Hawaii, and described in Chapter 2 of this report.

Internal Control Over Financial Reporting
In planning and performing our audit, we considered the department's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the basic financial statements and not to provide assurance on internal control over financial reporting. However, we noted certain matters involving internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control over financial reporting that, in our judgment, could adversely affect the department's ability to record, process, summarize, and report financial data consistent with the assertions of management in the basic financial statements. Reportable conditions have been reported to the Auditor, State of Hawaii, and described in Chapter 2 of this report.

A material weakness is a condition in which the design or operation of one or more internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the basic financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of internal control over financial reporting would not necessarily disclose all matters in internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.

This report is intended solely for the information and use of the Auditor, State of Hawaii, and the management of the department and is not intended to be and should not be used by anyone other than these specified parties.

/s/ KPMG LLP

Honolulu, Hawaii
November 8, 2002

Description of Basic Financial Statements

Basic financial statements

The following is a brief description of the basic financial statements audited by KPMG LLP, which are located at the end of this chapter.

Government-Wide Financial Statements
Statement of Net Assets (Exhibit 3.1). This statement is prepared using the accrual basis of accounting and is designed to display the financial position of the department at June 30, 2002. This approach includes reporting not just current assets and liabilities, but also capital assets and long-term liabilities. The department's net assets are classified as either invested in capital assets or unrestricted.

Statement of Activities (Exhibit 3.2). This statement is prepared using the accrual basis of accounting and presents a comparison between direct expenses and program revenues in a format that focuses on the cost of each of the department's functions. Under this approach, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred, regardless of when the related cash flows take place.

Fund Financial Statements
Balance Sheet - Governmental Funds (Exhibit 3.3). This statement presents the assets, liabilities, and fund balances of the department's governmental funds and is prepared using the current financial resources measurement focus and the modified accrual basis of accounting. Because the emphasis of this statement is on current financial resources, capital assets and long-term liabilities are not reported.

Statement of Revenues, Expenditures, and Changes in Fund Balances - Governmental Funds (Exhibit 3.4). This statement presents the revenues, expenditures, and other financing sources and uses of the department's governmental funds and is prepared using the current financial resources measurement focus and the modified accrual basis of accounting. Under this approach, revenues are recognized when measurable and available while expenditures are recorded when the related fund liability is incurred.

Statement of Fiduciary Net Assets (Exhibit 3.5). This statement presents the assets, liabilities, and net assets of the department's fiduciary fund at June 30, 2002.

Statement of Revenues and Expenditures – Budget and Actual (Budgetary Basis) – General and Economic Development Special Revenue Funds (Exhibit 3.6). This statement compares actual revenues and expenditures of the department's general and economic development special revenue funds on a budgetary basis to the budget adopted by the State Legislature for the year ended June 30, 2002.

Notes to Basic Financial Statements

Explanatory notes, which are pertinent to an understanding of the basic financial statements and financial condition of the department, are discussed in this section.

Note 1 – Financial Statement Presentation

Reporting Entity

The Department of Business, Economic Development and Tourism (department) is a department of the State of Hawaii (State). The department's basic financial statements present the financial position and changes in financial position of only that portion of the governmental activities and major fund information of the State that are attributable to the transactions of the department. The state comptroller maintains the central accounts for all state funds and publishes comprehensive financial statements for the State annually, which include the department's financial activities.

The department's objective is to make broad policy determinations with respect to economic development within the State and to stimulate research (through research and demonstration projects) in industrial and economic development that offers the most immediate promise to expand the State's economy. In addition, the department endeavors to understand those functions and activities of other governmental agencies and of private agencies that are related to economic development. The department also encourages initiative and creative thinking in harmony with its objectives.

The State has defined its reporting entity in accordance with Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*. This statement establishes standards for defining and reporting on the financial reporting entity. The basic criterion for including a potential component unit within the reporting entity is financial accountability. Other criteria include legal standing and fiscal dependency.

The department's basic financial statements consist of the department's financial activities and certain other agencies of the State, which are administratively attached to the department. The following agencies are blended component units of the State and are included in the department's basic financial statements:

- Aloha Tower Development Corporation
- Hawaii Strategic Development Corporation
- Hawaii Tourism Authority
- High Technology Development Corporation
- Land Use Commission
- Natural Energy Laboratory of Hawaii Authority
- Office of Planning

The department's basic financial statements do not include the financial statements of the Hawaii Community Development Authority or the Housing and Community Development Corporation of Hawaii.

Complete financial statements for the Hawaii Community Development Authority and the Housing and Community Development Corporation of Hawaii may be obtained at their respective administrative offices.

The basic financial statements of the department have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP), as applicable to governmental units. The GASB is the accepted standard-setting body for establishing governmental accounting and financial reporting principles.

The GASB has issued Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*; GASB Statement No. 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus*; GASB Statement No. 38, *Certain Financial Statement Note Disclosures*; and Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*. These pronouncements establish new financial reporting requirements and a new financial reporting model for state and local governments. The department adopted these pronouncements effective July 1, 2001. The following describes the more significant changes for the department.

Government-Wide Financial Statements

The reporting model includes a statement of net assets and a statement of activities prepared using full accrual accounting for all of the government's activities. This approach includes not just current assets and liabilities (such as cash and accounts payable) but also capital assets and long-term liabilities (such as buildings and accrued vacation payable). Accrual accounting also reports all of the revenues and cost of providing services each year, not just those received or paid in the current year or soon thereafter.

Statement of Net Assets

The statement of net assets is designed to display the financial position of the department. The department reports all capital assets in the government-wide statement of net assets and reports depreciation expense—the cost of "using up" capital assets—in the statement of activities. Net assets are classified into three categories: 1) invested in capital assets, 2) restricted, and 3) unrestricted. The department did not have any restricted net assets at June 30, 2002.

Statement of Activities

The new government-wide statement of activities reports expenses and revenues in a format that focuses on the cost of each of the department's functions. The expense of individual functions is compared to the revenues generated directly by the function (e.g., through user charges or intergovernmental grants).

Government-Wide and Fund Accounting

The basic financial statements include both government-wide (based on the department as a whole) and fund financial statements. While the previous reporting model emphasized fund types (the total of all funds of a particular type), in the new reporting model the focus is on either the department as a whole or major individual funds (within the fund financial statements). The government-wide statement of net assets is reflected on a full accrual, economic resource basis, which incorporates long-term assets and receivables as well as long-term debt and obligations. The department generally first uses restricted assets for expenses incurred for which both restricted and unrestricted assets are available.

The government-wide statement of activities reflects both the gross and net cost per functional category (Hawaii Tourism Authority, Hawaii Convention Center, Business Services and Development, etc.) which is otherwise being supported by general government revenues (transient accommodations tax, state allotted appropriations, interest, non-imposed employee fringe benefits, etc.). The statement of activities reduces gross expenses (including depreciation) by related program revenues. Program revenues must be directly associated with the function. The department does not allocate indirect expenses.

The department's fiduciary funds are presented in the fund financial statements. Since by definition these assets are being held for the benefit of a third party and cannot be used to address activities or obligations of the government, these funds are not incorporated into the government-wide statements.

The department uses funds to report on its financial position and the results of its operations. Fund accounting is designed to demonstrate legal compliance and to aid financial management by segregating transactions related to certain departmental functions or activities.

A fund is a separate accounting entity with a self-balancing set of accounts. The department uses two fund type categories: governmental and fiduciary. Each category, in turn, is divided into separate “fund types”:

Governmental funds – the department has the following major funds:

General Fund – is the general operating fund of the department. It is used to account for all financial resources except those required to be accounted for in another fund.

Economic Development Special Revenue Fund – is used to account for programs related to the development and promotion of industry and international commerce, energy development and management, economic research and analysis, and the utilization of resources.

Capital Projects Fund – is used to account for financial resources to be used for the acquisition and construction of the NELHA On Shore Distribution System, Oceanic Institute Aquatic Animal Hatchery, Volcano Art Center, and other capital assets.

Fiduciary funds – used to account for assets held on behalf of outside parties. Agency funds are generally used to account for assets that the department holds on behalf of others as their agent.

Note 2 – Summary of Significant Accounting Policies

Financial Statement Presentation, Basis of Accounting, and Measurement Focus
The department’s accounting policies conform to GAAP applicable to state and local governments as prescribed by GASB through its statements and interpretations. The government-wide statement of net assets and statement of activities are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and liabilities associated with the operation of these activities are included on the statement of net assets.

The accounting and financial reporting treatment applied to a fund is determined by its measurement focus. All governmental funds are accounted for using a current financial resources measurement focus. With this measurement focus, only current assets and liabilities are generally included on the balance sheet. Operating statements of these funds present increases (i.e., revenues and other financing sources) and decreases (i.e., expenditures and other financing uses) in net current assets.

The modified accrual basis of accounting is used by all governmental fund types and trust funds. Under the modified accrual basis of accounting, revenues such as interest are recognized when susceptible to accrual (i.e., when they become both measurable and available to finance operations of the fiscal year or liquidate liabilities existing at year-end).

Measurable means that the transaction amount can be determined. Available means that the amount is collected in the current fiscal year or soon enough after year-end to liquidate liabilities existing at the end of the fiscal year. The department considers receivables collected within 60 days after year-end to be available and recognizes them as revenues of the current year. Expenditures are recorded when the related fund liability is incurred.

The department reports deferred revenues on its statement of net assets and balance sheet. Deferred revenues arise when both the “measurable” and “available” criteria for recognition are not met in the current period. Deferred revenues also arise when the department receives resources before it has a legal claim to them, as when grant moneys are received prior to the incurrence of qualifying expenditures. In subsequent periods, when both revenue recognition criteria are met, or when the department has a legal claim to the resources, the liability for the deferred revenue is removed from the statement of net assets and balance sheet and revenue is recognized.

Encumbrances represent commitments related to unperformed contracts for goods or services. Encumbrance accounting, under which purchase orders, contracts, and other commitments for the expenditure of resources are recorded to reserve that portion of the applicable appropriation, is utilized in the governmental funds. Encumbrances outstanding at year-end are reported as reservations of fund balances and do not constitute expenditures or liabilities because the commitments will generally be honored during the subsequent fiscal year.

Investments
Investments in venture capital limited partnerships are carried at cost, which amounted to $6,942,000 at June 30, 2002. The fair value of these investments approximated $7,055,517 at June 30, 2002. Fair value of the department’s limited partnership interests is either based on the fair value of the underlying securities owned by the limited partnerships obtained from international and national security exchanges or is based on estimated values. The department has outstanding commitments to fund these venture capital funds of $4,358,000 at June 30, 2002.

Capital Assets
Capital assets are not capitalized in the funds used to acquire or construct them. Instead, capital acquisition and construction are reflected as expenditures in governmental funds, and the related assets are reported in the statement of net assets. Capital assets acquired by purchase are recorded at cost. Donated fixed assets are valued at the estimated fair market value on the date received. Maintenance, repairs, minor replacements, renewals, and betterments are charged to operations as incurred. Major replacements, renewals, and betterments are capitalized. Capital assets are defined as assets with an initial individual cost of $5,000 or more and are depreciated on the straight-line method over the estimated useful lives of the respective assets (land improvements – 15 years; buildings and improvements – 30 years; furniture, fixtures, and equipment – five to seven years). Depreciation is recorded on capital assets on the government-wide statement of activities.

Accrued Vacation Payable and Sick Leave
Department employees' accrued vacation payable is expected to be liquidated with future expendable resources and is therefore accrued in the statement of net assets. Sick leave is not convertible to pay upon termination of employment and is recorded as an expenditure when taken.

Program Revenues
The department charges various program fees that include office space and facility rental fees, ground rent fees, storage service fees, maintenance fees, and facility management fees.

Federal grant and assistance awards made on the basis of entitlement periods are recorded as revenue when available and entitlement occurs. All other federal reimbursement-type grants are recorded as intergovernmental receivables and revenues when the related expenditures are incurred.

Transient Accommodations Tax
In accordance with Sections 201B-11 and 237D-6.5, Hawaii Revised Statutes (HRS), funding for the department's economic development special revenue fund operations is derived from 37.9 percent of the transient accommodations tax. The transient accommodations tax is assessed at a rate of 7.25 percent on the gross rental or gross rental proceeds derived from providing transient accommodations.

Non-exchange Transactions
Effective July 1, 2000, the department adopted GASB Statement No. 33, *Accounting and Financial Reporting for Non-exchange Transactions*, which requires the department to record grant revenue only when all eligibility requirements have been met and amounts are available.

Intrafund and Interfund Transactions
Transfers of financial resources within the same fund are eliminated. Transfers from funds receiving revenues to funds through which the resources are to be expended are recorded as operating transfers. Nonrecurring or non-routine transfers of equity between funds are recorded as residual equity transfers.

Use of Estimates
The preparation of basic financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, as well as disclosure of contingent assets and liabilities at the date of the basic financial statements, and the reported amounts of revenues, expenditures, and other financing sources and uses during the reporting period. Actual results could differ from those estimates.

Note 3 – Budgeting and Budgetary Control

The budget of the department is a detailed operating plan identifying estimated costs and results in relation to estimated revenues. The budget includes 1) the programs, services, and activities to be provided during the fiscal year; 2) the estimated revenues available to finance the operating plan; and 3) the estimated spending requirements of the operating plan. The budget represents a process through which policy decisions are made, implemented, and controlled.

Revenue estimates are provided to the State Legislature at the time of budget consideration and are revised and updated periodically during the fiscal year. Amounts reflected as budgeted revenues in the statement of revenues and expenditures – budget and actual (budgetary basis) – general and economic development special revenue funds are those estimates as compiled and reviewed by the department. Budgeted expenditures are derived primarily from the General Appropriations Act of 2001 (Act 259, Session Laws of Hawaii of 2001), as amended by the Supplemental Appropriations Act of 2002 (Act 177, Session Laws of Hawaii of 2002), and from other authorizations contained in the State Constitution, HRS, and other specific appropriations acts in various Session Laws of Hawaii. Federal financial assistance program revenues are not included in the statement of revenues and expenditures – budget and actual (budgetary basis) – general and economic development special revenue funds.

All expenditures of these appropriated funds are made pursuant to the appropriations in the FY2001-03 biennial budget, as amended by subsequent supplemental appropriations.

The general and economic development special revenue funds have legally appropriated annual budgets. Capital projects fund appropriated budgets are for projects that may extend over several fiscal years.

The final legally adopted budget in the accompanying statement of revenues and expenditures – budget and actual (budgetary basis) – general and economic development special revenue funds represents the original appropriations, transfers, and other legally authorized legislative and executive changes.

The legal level of budgetary control is maintained at the appropriation line item level by department, program, and source of funds as established in the appropriations act. The governor is authorized to transfer appropriations between programs within the same department and source of funds; however, transfers of appropriations between departments generally require legislative authorization. Records and reports reflecting the detail level of control are maintained by and are available at the department. During the fiscal year ended June 30, 2002, there were no expenditures in excess of appropriations at the legal level of budgetary control.

To the extent not expended or encumbered, general and economic development special revenue funds appropriations generally lapse at the end of the fiscal year for which the appropriations are made. The State Legislature specifies the lapse dates and any other contingencies which may terminate the authorizations for other appropriations.

Budgets adopted by the State Legislature for the general and economic development special revenue funds are presented in the accompanying statement of revenues and expenditures – budget and actual (budgetary basis) – general and economic development special revenue funds. The department's annual budget is prepared on the modified accrual basis of accounting with several differences from the preparation of the statement of revenues, expenditures, and changes in fund balances, principally related to 1) encumbrance of purchase orders and contract obligations; 2) accrued revenues and expenditures; and 3) unbudgeted programs (federal award programs). The first two differences represent departures from GAAP.

A reconciliation of the budgetary to GAAP basis operating results for the fiscal year ended June 30, 2002 follows:

	General	Economic Development Special Revenue
Excess (deficiency) of revenues over expenditures – actual (budgetary basis)	$ 33,300	$(16,370,896)
Reserved for encumbrances at year-end	3,128,267	6,771,389*
Reserved for encumbrances at beginning of year	(3,828,547)	(5,364,785)*
Net accrued revenues and expenditures	217,679	38,767*
Unbudgeted revenues and other financing sources net of expenditures and other financing uses	(33,300)	94,699
Deficiency of revenues and other financing sources over expenditures and other financing uses – GAAP basis	$ (482,601)	$(14,830,826)

* Amount reflects the balances related to budgeted programs only.

Note 4 – Cash

The state Director of Finance is responsible for the safekeeping of all moneys paid into the State Treasury. The state Director of Finance pools and invests any moneys of the State, which in the director's judgment are in excess of amounts necessary for meeting the immediate requirements of the State. Legally authorized investments include obligations of, or guaranteed by, the U.S. Government, obligations of the State, federally-insured savings and checking accounts, time certificates of deposit, and repurchase agreements with federally-insured financial institutions.

The State established a policy whereby all unrestricted and certain restricted cash is invested in the State's investment pool. Cash accounts that participate in the investment pool accrue interest based on the average weighted cash balances of each account. The department records the pooled assets as cash in the State Treasury.

For demand or checking accounts and time certificates of deposit, the State requires that depository banks pledge collateral based on daily available bank balances. The use of daily available bank balances to determine collateral requirements results in available balances being under-collateralized at various times during the fiscal year. All securities pledged as collateral are held either by the State Treasury or by the State's fiscal agents in the name of the State.

Information regarding the carrying amount and corresponding bank balances of cash (which includes the department's cash in the State Treasury) and collateralization of cash balances is included in the State's comprehensive annual financial report.

The carrying value of the department's cash in bank balance of $106,028 equals the bank balance and was uncollateralized at June 30, 2002. Such balance primarily represents the department's bank accounts maintained for out-of-state operations and security deposits held for the Foreign-Trade Zone Division and the High Technology Development Corporation.

Note 5 - Accounts and Loans Receivable

At June 30, 2002, accounts and loans receivable consisted of the following:

	Accounts Receivable	Loans Receivable
Foreign-Trade Zone Division	$ 240,869	$ —
Natural Energy Laboratory of Hawaii Authority	274,329	—
High Technology Development Corporation	303,800	—
Financial Assistance Branch:		
Hawaii Capital Loan Program	—	8,801,213
Hawaii Community-Based Development Loan Program	—	332,356
Hawaii Innovation Development Loan Program	—	265,302
Hawaii Disaster Commercial Loan Program	—	50,695
	$ 818,998	$ 9,449,566
Less allowance for doubtful accounts	(501,857)	(4,714,135)
Accounts and loans receivable, net	$ 317,141	$ 4,735,431

Note 6 - Due to Other State Agencies

The Aloha Tower Development Corporation (corporation) is a State agency established under Chapter 206J, HRS, primarily to redevelop the

Aloha Tower complex. The complex encompasses Piers 5 to 23 of Honolulu Harbor. In September 1993, the state Department of Transportation – Harbors Division (harbors) entered into a lease with the Aloha Tower Development Corporation, which grants the leasehold interest in portions of the Aloha Tower complex to the corporation. The Aloha Tower Development Corporation is required annually to reimburse harbors for any losses in revenues during the term of the lease caused by any action of the corporation or the developer and to provide replacement facilities for maritime activities at no cost to harbors.

In September 1993, the corporation subleased lands surrounded by Piers 8 and 9 and a portion of land surrounded by Pier 10 to a developer and entered into a capital improvements, maintenance, operations, and securities agreement (operations agreement) with the developer and harbors. Harbors continues to operate the harbor facilities at Piers 8, 9, and 10. The lease between the Aloha Tower Development Corporation and the developer requires the developer to construct, at the developer's cost, various facilities as designated in the developer's proposal and to reimburse harbors for all losses in revenues and increased expenses, which may be incurred by harbors. The corporation, harbors, and the developer agreed that in lieu of reimbursing harbors for losses in revenues during the construction period, the developer would perform certain work to repair the structure of Piers 8 through 11, the cost of which would otherwise be incurred by harbors. The developer offset the maximum allowable cost of repair of $1,100,000 against its obligation to harbors for losses in revenues.

As of June 30, 2002, the first phase of the Aloha Tower complex development has been completed.

Pursuant to this operations agreement, the developer is current on amounts owed to the Aloha Tower Development Corporation as of June 30, 2002. Pursuant to the corporation's lease, the corporation owes harbors approximately $2,829,000 as of June 30, 2002. This amount is reflected in the economic development special revenue fund in the department's basic financial statements.

Note 7 - Capital Assets

Changes in capital assets during the fiscal year ended June 30, 2002 were as follows:

	Restated Balance July 1, 2001 (Note 12)	Additions	Deductions	Balance June 30, 2002
Capital assets not being depreciated:				
Land	$ 134,446,508	$ —	$ —	$ 134,446,508
Construction in progress	6,502,501	11,253,502	—	17,756,003
Total capital assets not being depreciated	$ 140,949,009	$ 11,253,502	$ —	$ 152,202,511
Other capital assets:				
Land improvements	$ 311,128	$ —	$ —	$ 311,128
Buildings and improvements	250,533,745	—	—	250,533,745
Equipment	2,963,415	66,794	35,809	2,994,400
Total other capital assets	$ 253,808,288	$ 66,794	$ 35,809	$ 253,839,273
Less accumulated depreciation for:				
Land improvements	$ 176,306	$ 20,742	$ —	$ 197,048
Buildings and improvements	46,039,280	8,350,870	—	54,390,150
Furniture, fixtures, and equipment	2,236,358	285,638	23,343	2,498,653
Total accumulated depreciation	$ 48,451,944	$ 8,657,250	$ 23,343	$ 57,085,851
Other capital assets, net	$ 205,356,344	$ (8,590,456)	$ 12,466	$ 196,753,422
Total capital assets, net	$ 346,305,353	$ 2,663,046	$ 12,466	$ 348,955,933

The accumulated depreciation balances at July 1, 2001 were restated to record accumulated depreciation in accordance with the adoption of GASB Statement No. 34. The gross cost balances at July 1, 2001 were also restated to reflect an increase in the department's capitalization threshold from $1,000 to $5,000. Balances as of July 1, 2001 were restated as follows:

	Balance July 1, 2001	Restatement	Restated Balance July 1, 2001
Land	$ 127,765,894	$ 6,680,614	$ 134,446,508
Land improvements	—	311,128	311,128
Construction in progress	—	6,502,501	6,502,501
Buildings and improvements	245,342,520	5,191,225	250,533,745
Furniture, fixtures, and equipment	10,428,781	(7,465,366)	2,963,415
Subtotal	$ 383,537,195	$ 11,220,102	$ 394,757,297
Accumulated depreciation	—	(48,451,944)	(48,451,944)
Totals	$ 383,537,195	$ (37,231,842)	$ 346,305,353

Depreciation expense was charged to functions of the department as follows:

Hawaii Convention Center	$ 7,055,014
Business Services and Development	240,701
General Support for Economic Development	423,363
High Technology Development Corporation	760,704
Energy Development and Management	824
Natural Energy Laboratory of Hawaii Authority	68,086
Office of Planning	2,992
Foreign-Trade Zone	105,566
Total depreciation expense	$ 8,657,250

Note 8 - Accrued Vacation

Changes in accrued vacation payable during the fiscal year ended June 30, 2002 were as follows:

Balance, July 1, 2001	$ 2,186,682
Net increase in accrued vacation payable	70,367
Balance, June 30, 2002	$ 2,257,049

Note 9 - Retirement Benefits

Employees' Retirement System of the State of Hawaii

All eligible State and county employees, including department employees, are required by Chapter 88, HRS, to become members of the Employees' Retirement System of the State of Hawaii (ERS), a cost-sharing multiple-employer public employee retirement plan. The ERS provides retirement benefits as well as death and disability benefits. The ERS is governed by a Board of Trustees. All contributions, benefits, and eligibility requirements are established by Chapter 88, HRS, and can be amended by legislative action. The ERS issues a comprehensive annual financial report that is available to the public. That report may be obtained by writing to the ERS at 201 Merchant Street, Suite 1400, Honolulu, Hawaii 96813.

Prior to June 30, 1984, the plan consisted of only a contributory option. In 1984, legislation was enacted to add a new noncontributory option for ERS members who are also covered under Social Security. Police officers, firefighters, judges, elected officials, and persons employed in positions not covered by Social Security are precluded from the noncontributory option. The noncontributory option provides for reduced benefits and covers most eligible employees hired after June 30, 1984. Employees hired before that date were allowed to continue under the contributory option or to elect the new noncontributory option and receive a refund of employee contributions. All benefits vest after five and ten years of credited service under the contributory and noncontributory options, respectively.

Both options provide a monthly retirement allowance based on the employee's age, years of credited service, and average final compensation (AFC). The AFC is the average salary earned during the five highest paid years of service, including the vacation payment, if the employee became a member prior to January 1, 1971. The AFC for members hired on or after that date is based on the three highest paid years of service, excluding the vacation payment.

Most covered employees of the contributory option are required to contribute 7.8 percent of their salary. Police officers, firefighters, investigators of the departments of the County Prosecuting Attorney and the Attorney General, narcotics enforcement investigators, and public safety investigators are required to contribute 12.2 percent of their salary. The funding method used to calculate the total employer contribution requirement is the entry age normal actuarial cost method. Under this method, employer contributions to the ERS are comprised of normal cost plus level annual payments required to liquidate the unfunded actuarial liability over the remaining period of 19 years from July 1, 1997.

The department's contribution for the fiscal year ended June 30, 1999 was approximately $614,000, at the rate of 5.78 percent, of annual covered payroll. The department contributed 100 percent of its required contributions for that year. Changes in salary growth assumptions and investment earnings pursuant to Act 100, Session Laws of Hawaii of 1999, resulted in no required contribution for the fiscal years ended June 30, 2002, 2001, and 2000.

Post-Retirement Health Care and Life Insurance Benefits
In addition to providing pension benefits, the State, pursuant to Chapter 87, HRS, provides certain health care and life insurance benefits to all qualified employees. For employees hired before July 1, 1996, the State pays the entire monthly health care premium for employees retiring with ten or more years of credited service, and 50 percent of the monthly premium for employees retiring with fewer than ten years of credited service. For employees hired after June 30, 1996, and who retire with fewer than ten years of service, the State makes no contributions. For those retiring with at least ten years but fewer than 15 years of service, the State pays 50 percent of the retired employees' monthly Medicare or non-Medicare premium. For employees hired after June 30, 1996, and who retire with at least 15 years but fewer than 25 years of service, the State pays 75 percent of the retired employees' monthly Medicare or non-Medicare premium; for those retiring with over 25 years of service, the State pays the entire health care premium. There are currently approximately 22,100 state retirees receiving such benefits. Free life insurance coverage for retirees and free dental coverage for dependents under age 19 are also available. Retirees covered by the medical portion of Medicare are eligible to receive a reimbursement of the basic medical coverage premium. Contributions are financed on a pay-as-you-go basis.

The department's contribution for post-retirement health care and life insurance benefits for the fiscal year ended June 30, 2002 was approximately $661,000. A substantial portion of this amount is included in the non-imposed fringe benefits amount (Note 10).

Note 10 - Non-imposed Employee Fringe Benefits

Payroll fringe benefit costs of department employees funded by state appropriations (general fund) are assumed by the State and are not charged to the department's operating funds. These costs, totaling approximately $1,468,272 for the fiscal year ended June 30, 2002, have been reported as revenues and expenditures of the department's general fund.

Payroll fringe benefit costs related to federally-funded salaries are not assumed by the State and are recorded as expenditures in the department's economic development special revenue fund.

Note 11 - Fund Balance Deficit

The general fund had a deficit in its unreserved fund balance at June 30, 2002 of $69,301. The deficit resulted from recognition of expenditures under GAAP in FY2001-02 and will be funded with FY2002-03 state allotted appropriations.

Note 12 - Commitments and Contingencies

Leases
The department leases office facilities and equipment under various operating leases expiring through 2006. Future minimum lease commitments of noncancelable operating leases as of June 30, 2002 were as follows:

Fiscal year ending June 30:	
2003	$ 161,300
2004	130,900
2005	113,400
2006	63,000
2007	500
Total	$ 469,100

The department's rental expenditures for the fiscal year ended June 30, 2002 were approximately $99,000.

Accumulated Sick Leave
Sick leave accumulates at the rate of one and three-quarters working days for each month of service without limit, but may be taken only in the event of illness and is not convertible to pay upon termination of employment. However, an employee who retires or leaves government service in good standing with 60 days or more of unused sick leave is entitled to additional service credit in the ERS. At June 30, 2002, accumulated sick leave was approximately $6,995,000.

Deferred Compensation Plan
The State offers its employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457. The plan, available to all state employees, permits employees to defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency.

All plan assets are held in a trust fund to protect them from claims of general creditors. The State has no responsibility for loss due to the investment or failure of investment of funds and assets in the plan, but does have the duty of due care that would be required of an ordinary prudent investor.

Risk Management
GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues,* establishes accounting and financial reporting standards for risk financing and insurance related activities of state governmental entities and requires the recordation of a liability for risk financing and insurance related losses if it is determined

that a loss has been incurred and the amount can be reasonably estimated. The State retains various risks and insures certain excess layers with commercial insurance companies. Settled claims have not exceeded the coverage provided by commercial insurance companies in any of the past three fiscal years.

The State has an insurance policy with a variety of insurers in a variety of layers for property coverage. The deductible is $250,000 per occurrence. The deductible for windstorm coverage is 3 percent of loss subject to a $250,000 per occurrence minimum. The limit of loss per occurrence is $25,000,000. This policy includes earthquake and flood coverage whose limit of loss per occurrence is $25,000,000 with a deductible of 3 percent of loss subject to the $250,000 deductible.

Claims under $10,000 are handled by the risk management office of the state Department of Accounting and General Services. All other claims are handled by the state Department of the Attorney General. The State has a personal injury and property damage liability insurance policy, including automobile and public errors and omissions, in force with a $3,000,000 deductible per occurrence. The annual aggregate per occurrence is $28,000,000.

The State generally self-insures its automobile no-fault and workers' compensation losses. Automobile losses are administered by third-party administrators. The State administers its workers' compensation losses. A liability for workers' compensation and general liability claims is established if information indicates that a loss has been incurred as of June 30, 2002 and the amount of the loss can be reasonably estimated. The liability also includes an estimate for amounts incurred but not reported. The estimated losses will be paid from legislative appropriations of the state general fund and not by the department.

Litigation

From time to time the department is named as a defendant in various legal proceedings. Although the department and its counsel are unable to express opinions as to the outcome of the litigation, it is their opinion that any potential liability arising therefrom will not have a material adverse effect on the financial position of the department because judgments, if any, against the department are judgments against the State and would be paid by legislative appropriations of the state general fund and not by the department.

Note 13 - Accounting Changes and Restatements

During FY2001-02, the department adopted GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*. The department also raised the capitalization threshold for capital assets from $1,000 to $5,000.

The accumulated depreciation balances at July 1, 2001 were restated to record accumulated depreciation in accordance with the adoption of GASB Statement No. 34. The gross cost balances at July 1, 2001 were also restated to reflect an increase in the department's capitalization threshold from $1,000 to $5,000.

The following table shows beginning net assets restated for the effects of implementation of GASB Statement No. 34 and change in accounting policy.

Fund balance, as previously reported at July 1, 2001	$ 83,917,239
GASB Statement No. 34 and accounting policy adjustments:	
Net capital assets (Note 7)	346,305,353
Net assets as of July 1, 2001, as restated	$ 430,222,592

Exhibit 3.1

DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM

STATE OF HAWAII

Statement of Net Assets

June 30, 2002

Assets:		
Cash in state treasury (Note 4)		$ 53,790,386
Cash in bank (Note 4)		106,028
Petty cash		56,050
Investment in venture capital limited partnerships, at cost (Note 2)		6,942,000
Receivables:		
Accounts, net (Note 5)		317,141
Loans, net (Note 5)		4,735,431
Interest		40,136
Due from grantor		163,811
Due from Hawaii Convention Center		282,445
Capital assets (Note 7):		
Land and construction in progress	$ 152,202,511	
Other capital assets, net	196,753,422	
Capital assets, net		348,955,933
Total assets		$ 415,389,361
Liabilities:		
Vouchers payable		$ 3,545,085
Accrued payroll		496,650
Due to other state agencies (Note 6)		2,829,000
Due to State General Fund		56,050
Deferred revenues		1,146,202
Accrued vacation payable (Note 8):		
Due within one year		593,604
Due in more than one year		1,663,445
Total liabilities		$ 10,330,036
Net assets:		
Invested in capital assets	$ 348,955,933	
Unrestricted	56,103,392	
Total net assets		$ 405,059,325

See accompanying notes to basic financial statements.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM**

STATE OF HAWAII

Statement of Activities

Year Ended June 30, 2002

	Program expenses (Notes 6, 9, 10, and 11)	Program revenues: Charges for services	Program revenues: Operating grants and contributions	Net expense and changes in net assets
Governmental activities:				
Hawaii Tourism Authority	$ 70,879,472	$ —	$ —	$ 70,879,472
Hawaii Convention Center	19,866,143	—	—	19,866,143
Business services and development	13,311,109	357,434	6,598,542	6,355,133
General support for economic development	4,764,052	14,327	1,381,434	3,368,291
Hawaii Strategic Development Corporation	3,956,615	—	—	3,956,615
High Technology Development Corporation	3,768,441	1,448,392	—	2,320,049
Energy development and management	3,737,771	88,595	2,220,900	1,428,276
Natural Energy Laboratory of Hawaii Authority	2,821,744	1,441,857	—	1,379,887
Office of Planning	2,257,444	—	—	2,257,444
Foreign-Trade Zone	1,524,810	1,450,832	—	73,978
Aloha Tower Development Corporation	1,482,285	333,333	—	1,148,952
Economic planning and research for economic development	1,313,588	—	—	1,313,588
Land Use Commission	518,007	—	—	518,007
Hawaii Tourism Office	34,386	—	—	34,386
Clean Hawaii Center	3,231	—	3,231	—
Total governmental activities	$ 130,239,098	$ 5,134,770	$ 10,204,107	$ 114,900,221
General revenues:				
Transient accommodations tax				$ 59,743,471
State allotted appropriations, net of reversions and lapses				26,408,648
Lapsed appropriations related to previous years				(732,616)
Interest				2,381,887
Nonimposed employee fringe benefits (Notes 9 and 10)				1,468,272
Other				567,190
Total general revenues				$ 89,836,852
Transfers				$ (99,898)
Change in net assets				$ (25,163,267)
Net assets at July 1, 2001, as restated (Note 13)				430,222,592
Net assets at June 30, 2002				$ 405,059,325

See accompanying notes to basic financial statements.

Exhibit 3.3

DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM

STATE OF HAWAII

Balance Sheet – Governmental Funds

June 30, 2002

Assets	General	Economic Development Special Revenue	Capital Projects	Total Governmental Funds
Cash in state treasury (Note 4)	$ 4,220,542	$ 44,169,825	$ 5,400,019	$ 53,790,386
Cash in bank (Note 4)	—	106,028	—	106,028
Petty cash	34,000	22,050	—	56,050
Investment in venture capital limited partnerships, at cost (Note 2)	—	6,942,000	—	6,942,000
Receivables:				
Accounts, net (Note 5)	—	317,141	—	317,141
Loans, net (Note 5)	—	4,735,431	—	4,735,431
Interest	—	40,136	—	40,136
Due from grantor	—	163,811	—	163,811
Due from Hawaii Convention Center	282,445	—	—	282,445
Total assets	$ 4,536,987	$ 56,496,422	$ 5,400,019	$ 66,433,428
Liabilities and Fund Balances				
Liabilities:				
Vouchers payable	$ 600,787	$ 2,088,275	$ 856,023	$ 3,545,085
Accrued payroll	304,305	192,345	—	496,650
Due to other state agencies (Note 6)	—	2,829,000	—	2,829,000
Due to State General Fund	34,000	22,050	—	56,050
Deferred revenues	—	1,146,202	—	1,146,202
Total liabilities	$ 939,092	$ 6,277,872	$ 856,023	$ 8,072,987
Fund balances (deficit):				
Reserved for encumbrances	$ 3,667,196	$ 14,914,634	$ 3,367,301	$ 21,949,131
Reserved for capital projects	—	—	1,176,695	1,176,695
Reserved for other purposes	—	88,105	—	88,105
Unreserved	(69,301)	35,215,811	—	35,146,510
Total fund balances	$ 3,597,895	$ 50,218,550	$ 4,543,996	$ 58,360,441
Total liabilities and fund balances	$ 4,536,987	$ 56,496,422	$ 5,400,019	
Amounts reported in the statement of net assets are different because (see Note 1):				
Capital assets used in governmental activities are not financial resources and therefore are not reported in the funds				348,955,933
Long-term liabilities are not due and payable in the current period and therefore are not reported in the funds				(2,257,049)
Net assets of governmental activities				$ 405,059,325

See accompanying notes to basic financial statements.

DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM

STATE OF HAWAII

Statement of Revenues, Expenditures, and Changes in Fund Balances – Governmental Funds

Year Ended June 30, 2002

	General	Economic Development Special Revenue	Capital Projects	Total Governmental Funds
Revenues:				
Transient accommodations tax	$ —	$ 59,743,471	$ —	$ 59,743,471
State allotted appropriations, net of reversions and lapses	25,125,648	—	1,283,000	26,408,648
Intergovernmental	—	10,204,107	—	10,204,107
Charges for current services	—	5,134,770	—	5,134,770
Interest	—	2,381,887	—	2,381,887
Nonimposed employee fringe benefits (Notes 9 and 10)	1,468,272	—	—	1,468,272
Other	—	567,190	—	567,190
Total revenues	$ 26,593,920	$ 78,031,425	$ 1,283,000	$ 105,908,345
Expenditures (Notes 6, 9, 10, and 11):				
Hawaii Tourism Authority	—	70,731,211	—	70,731,211
Hawaii Convention Center	12,749,069	—	—	12,749,069
Business services and development	3,934,426	8,737,336	—	12,671,762
Hawaii Strategic Development Corporation	—	3,924,598	—	3,924,598
General support for economic development	2,466,433	1,365,563	—	3,831,996
Energy development and management	1,250,724	2,231,539	—	3,482,263
High Technology Development Corporation	1,337,503	1,590,722	—	2,928,225
Natural Energy Laboratory of Hawaii Authority	1,114,939	1,549,840	—	2,664,779
Office of Planning	1,965,716	—	—	1,965,716
Aloha Tower Development Corporation	—	1,440,294	—	1,440,294
Foreign-Trade Zone	—	1,357,519	—	1,357,519
Economic planning and research for economic development	1,147,280	—	—	1,147,280
Land Use Commission	446,798	—	—	446,798
Hawaii Tourism Office	34,386	—	—	34,386
Clean Hawaii Center	—	3,231	—	3,231
Capital outlays	—	—	11,253,502	11,253,502
Total expenditures	$ 26,447,274	$ 92,931,853	$ 11,253,502	$ 130,632,629
Excess (deficiency) of revenues over expenditures	$ 146,646	$ (14,900,428)	$ (9,970,502)	$ (24,724,284)
Other financing sources (uses):				
Operating transfers in	$ —	$ 136,200	$ —	$ 136,200
Operating transfers out	(136,200)	—	—	(136,200)
Operating transfer to the State Department of Accounting and General Services	(33,300)	(66,598)	—	(99,898)
Lapsed appropriations related to previous years	(459,747)	—	(272,869)	(732,616)
Total other financing source (uses), net	$ (629,247)	$ 69,602	$ (272,869)	$ (832,514)
Deficiency of revenues and other financing sources over expenditures and other financing uses	$ (482,601)	$ (14,830,826)	$ (10,243,371)	$ (25,556,798)
Fund balances, July 1, 2001	4,080,496	65,049,376	14,787,367	
Fund balances, June 30, 2002	$ 3,597,895	$ 50,218,550	$ 4,543,996	
Amounts reported in the statement of net assets are different because (see Note 1):				
Governmental funds report capital outlays as expenditures; however, in the statement of activities, the cost of those assets is allocated over their estimated useful lives as depreciation expense. This is the amount by which capital outlays exceeded depreciation in the current period				2,663,046
Some expenses reported in the statement of activities do not require the use of current financial resources and therefore are not reported as expenditures in governmental funds				(2,269,515)
Change in net assets				$ (25,163,267)

See accompanying notes to basic financial statements.

Exhibit 3.5

DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM

STATE OF HAWAII

Statement of Fiduciary Net Assets

Fiduciary Fund

June 30, 2002

		Agency Funds
Assets:		
Cash in state treasury (Note 4)	$	203,295
Cash in bank (Note 4)		41,948
Total assets	$	245,243
Liabilities:		
Deposits payable		245,243
Net assets	$	—

See accompanying notes to basic financial statements.

DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM

STATE OF HAWAII

Statement of Revenues and Expenditures – Budget and Actual
(Budgetary Basis) – General and Economic Development Special Revenue Funds

Year Ended June 30, 2002

	General Fund				Economic Development Special Revenue Fund			
	Original Budget	**Final Budget**	**Actual (Budgetary Basis)**	**Variance Favorable (Unfavorable)**	**Original Budget**	**Final Budget**	**Actual (Budgetary Basis)**	**Variance Favorable (Unfavorable)**
Revenues:								
State allotted appropriations, net of reversions and lapses	$ 26,917,523	$ 25,506,722	$ 25,125,648	$ (381,074)	$ —	$ —	$ —	$ —
Other	—	—	—	—	132,491,425	92,857,587	67,245,581	(25,612,006)
Total revenues	$ 26,917,523	$ 25,506,722	$ 25,125,648	$ (381,074)	$ 132,491,425	$ 92,857,587	$ 67,245,581	$ (25,612,006)
Expenditures:								
Hawaii Tourism Authority	$ —	$ —	$ —	$ —	$ 110,782,012	$ 71,057,164	$ 70,762,537	$ 294,627
Hawaii Convention Center	15,000,000	13,027,147	12,972,378	54,769	—	—	—	—
Commerce and industry	3,138,039	3,212,526	3,102,419	110,107	8,185,569	8,202,447	3,830,509	4,371,938
Energy development and management	1,394,333	1,416,546	1,279,227	137,319	100,000	100,000	—	100,000
General support for economic development	1,931,253	2,211,861	2,195,627	16,234	—	—	—	—
High Technology Development Corporation	1,499,177	1,509,023	1,457,033	51,990	3,461,442	3,481,759	1,911,220	1,570,539
Natural Energy Laboratory of Hawaii Authority	959,447	958,860	952,683	6,177	1,981,000	1,981,000	1,292,801	688,199
Office of Planning	1,662,219	1,782,159	1,761,791	20,368	—	—	—	—
Aloha Tower Development Corporation	—	—	—	—	1,503,552	1,518,296	357,458	1,160,838
Economic planning and research for economic development	916,162	979,362	972,009	7,353	—	—	—	—
Foreign-Trade Zone	—	—	—	—	1,973,377	2,008,498	1,542,120	466,378
Land Use Commission	416,893	409,238	399,181	10,057	—	—	—	—
Hawaii Strategic Development Corporation	—	—	—	—	4,104,473	4,108,423	3,919,832	188,591
Clean Hawaii Center	—	—	—	—	400,000	400,000	—	400,000
Total expenditures	$ 26,917,523	$ 25,506,722	$ 25,092,348	$ 414,374	$ 132,491,425	$ 92,857,587	$ 83,616,477	$ 9,241,110
Excess (deficiency) of revenues over expenditures	$ —	$ —	$ 33,300	$ 33,300	$ —	$ —	$ (16,370,896)	$ (16,370,896)

See accompanying notes to basic financial statements.

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Response of the Affected Agency

Comments on Agency Response

We transmitted a draft of this report to the Department of Business, Economic Development and Tourism (department) on February 21, 2003. A copy of the transmittal letter to the department is included as Attachment 1. The response of the department is included as Attachment 2.

The department agrees with some of our findings and has begun to address some of our recommendations. In its response, the department stated that a formal marketing strategy was not in place due to the narrowing of the loan target group by the past administration to high technology and biotechnology loans. However, we note that the department gave out one loan each in FY1997-98 and FY1998-99. Once again, a formal marketing strategy will help the department achieve the goals of the loan programs that it administers.

In addition, the department noted that the high rate of loan delinquency is due to the Attorney General's office not writing off loans deemed uncollectible on a timely basis. While this may contribute to the high rate of loan delinquency, the department's internal handling of loans contributes significantly to the problem. The department acknowledged that the immediate follow up on delinquent loans can be achieved through better coordination between the Financial Support Branch and the department's accounting section. The department does not agree with our finding that the relationship with lead banks could be improved.

Furthermore, the department indicated that the Auditor is misrepresenting information when stating that not all loan files contain a loan "checklist." We stand by our finding. Although the department staples a copy of the checklist to each loan file, most of the checklists were either blank or incomplete. Merely including the checklist in each of the loan files does not mitigate the problem. The department must properly use the checklist in order to ensure that each of the loan files includes proper and adequate documentation.

The department agreed with our recommendation that loan repayment checks be deposited in a timely manner and is revising department procedures to require that checks are deposited on a daily basis.

In a separate response attached to the department's response, the Hawaii Tourism Authority did not fully agree with our findings, regarding its management of contracts. In its response, the authority noted that while it desires to achieve absolute contract compliance, there are extenuating circumstances that preclude strict compliance by a contractor and the authority.

In addition, the authority indicated that it believes that it obtains sufficient and ample assurances from its contractors that the services provided are those that would be described in a written contract. Because of these assurances the authority does not believe that it would be exposed to the "jeopardy" of any legal problems. We disagree with the authority. Contractor assurances are not equivalent to an executed contract and do not provide the authority with the same protections.

Furthermore, the authority stated that the example identified in the report of a contractor's payment dated prior to the final reports' receipt and approval is incorrect. The authority noted that the check was issued but withheld from the contractor until the contractor's final report was received and approved. We would be unable to verify the authority's claims in this situation. However, it is not considered a reasonable practice to have checks issued and held by the authority, as the checks then become vulnerable to theft. Also, the check was for $40,000 and, based on the authority's claims, was held for about a month.

The authority also noted that it will immediately serve notice upon all of its contractors that it will now insist upon strict compliance with its technical contract management requirements. At the same time, the authority will pursue legislative efforts for executive autonomy as a means of addressing the untimely execution of contracts.

Finally, the department agreed with our findings and recommendations regarding the unencumbering of closed, terminated, and/or completed encumbrances and its petty cash funds and is taking measures to ensure policies and procedures are improved and properly implemented.

STATE OF HAWAII
OFFICE OF THE AUDITOR
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917

MARION M. HIGA
State Auditor

(808) 587-0800
FAX: (808) 587-0830

February 21, 2003

COPY

The Honorable Theodore E. Liu, Director
Department of Business, Economic Development
and Tourism
No. 1 Capitol District
250 South Hotel Street
Honolulu, Hawaii 96813

Dear Mr. Liu:

Enclosed for your information are three copies, numbered 6 to 8 of our confidential draft report, *Financial Audit of the Department of Business, Economic Development and Tourism.* We ask that you telephone us by Tuesday, February 25, 2003, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Thursday, February 27, 2003.

The Governor and presiding officers of the two houses of the Legislature have also been provided copies of this confidential draft report.

Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

Marion M. Higa

Marion M. Higa
State Auditor

Enclosures

ATTACHMENT 2

LINDA LINGLE
GOVERNOR
THEODORE E. LIU
DIRECTOR
RAYMOND M. JEFFERSON
DEPUTY DIRECTOR

DEPARTMENT OF BUSINESS, ECONOMIC DEVELOPMENT & TOURISM

No. 1 Capitol District Building, 250 South Hotel Street, 5th Floor, Honolulu, Hawaii 96813
Mailing Address: P.O. Box 2359, Honolulu, Hawaii 96804
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February 28, 2003

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OFC. OF THE AUDITOR
STATE OF HAWAII

Ms. Marion Higa
State Auditor
Office of the Auditor
465 South King Street, Room 500
Honolulu, Hawaii 96813

Dear Ms. Higa:

Thank you for the opportunity to respond to the draft report, Financial Audit of the Department of Business, Economic Development and Tourism. We are pleased that the Independent Auditor's Report states that there were no material weaknesses in the internal control structure of the department.

The following are our comments regarding specific areas of concern:

<u>The Department's management of its loan programs is ineffective.</u>

The Financial Support Branch does have brochures and loan package handouts that are readily available to the public. Due to the past administration's policy of doing high technology and biotechnology loans a formal marketing strategy was not in place due to the loan target group being narrowed.

The continued high rate of delinquency is due to loans which are deemed uncollectible are not written off on a timely basis by the past administration of the Attorney General's office.

The department generates monthly manual Contractual Delinquent Reports. Therefore, the immediate follow up on delinquent loans will be achieved with better coordination between the Financial Support Branch and the department's accounting section.

Loan collection on participation loans is done by the lead bank. Most lending institutions refer commercial loan collection to their specialized Loan Collection Department. Their collection department is versed in its collection techniques/activities and it ensures that they are within guidelines established by the state as well as the federal government. They may not provide us with written collection activities on the account, however, will verbally discuss matters that they feel is of the utmost importance and that could have an effect on our participation loan. We feel that the lending institution is providing its valued service in collection and ensuring that they adhere to the department's Participation Agreement in the proper service of our participation loans. The lending institutions also strive to maintain a low delinquency ratio.

When available, the borrowers are required to provide the department with invoices that the loan proceeds were properly used. However, in several situations we are unable to specifically target the monies being spent when the purposes indicate that the proceeds are for "working capital".

All loans files contain a loan "checklist". This checklist is being properly used to ensure that the loan is properly documented. The information provided by the auditor in this situation is being misrepresented.

Since July, 2002, the procedure to deposit loan repayment checks was revised to require that checks be deposited daily. The Department has been making every effort to deposit checks on a timely basis to improve the accounting function for the deposit of loan repayments.

The Hawaii Tourism Authority does not adequately manage its contracts.

Please refer to response from the Hawaii Tourism Authority.

The Department's failure to lapse unnecessary encumbrances has deprived the State of the use of fund for other priorities.

The Department's Contracts Section has been working with the Departmental programs since November, 2002 to close out all of the inactive contracts. To date, we have closed out or are in the process of closing out 90% of these inactive contracts.

The Department will continue to work with its programs to ensure the timely closing of inactive contracts by providing a quarterly listing of all outstanding contracts nearing expiration to the programs for their determination as to whether a contract should be closed or extended. Non-responses or unreasonable extensions will be forwarded to the Administrative Services Officer for a final decision.

The Department has developed a contracts manual and has held detailed training sessions with the programs on contracts procedures. The Department will be adding detailed contracts closure procedures to supplement the contract manual including the web version of the manual for program staff. Additionally, classes will be held to further instruct the program staff responsible for contract monitoring and contracts closure procedures.

In addition, the Department's Fiscal Section will work with programs to ensure the timely closing of inactive encumbrances for purchase orders by performing a quarterly review of purchase orders and reducing encumbrance balances that are no longer required for obligations.

The Department's administration of petty cash funds must be improved.

Since November, 2002, the Department has been enforcing compliance with established petty cash fund procedures by requiring programs submit a reconciliation of its petty cash fund total with each replenishment request. Also, the overage in the Foreign Trade Zone's petty cash fund has been corrected by the deposit of the overage amount to the State General Fund in accordance with the State's accounting policies.

A significant decrease in the volume of transactions processed from the administration petty cash fund has resulted primarily from the establishment of additional petty cash funds at the agency level. The Department has recently completed an evaluation of the current requirements for its administration petty cash fund and is in the process of reducing the petty cash fund by returning the excess amount to the State general fund.

To improve the administration of petty cash funds, the Department will continue to require petty cash fund total reconciliations be submitted with each replenishment request, conduct periodic reviews of the petty cash fund account reconciliations including unannounced cash counts, and take steps to resolve any petty cash fund discrepancy with the program as soon as it is detected. In addition, the Department will be reissuing the regulations governing petty cash funds to affected programs and will monitor program compliance with established procedures.

I note that your audit was for the period July 1, 2001, to June 30, 2002, and that KPMG LLP's audit was conducted from July 2002 through November 2002. On January 9, 2003, Governor Linda Lingle announced me as her nominee to be the new Director of DBEDT. My senior management team and I will continue to study your report and we look forward to having discussions with you and your staff members regarding remedial measures.

Sincerely,

Theodore E. Liu

LINDA LINGLE
Governor

Hawaii Tourism Authority

REX D. JOHNSON
President and Chief Executive Officer

Hawaii Convention Center, 1801 Kalakaua Avenue, Honolulu, Hawaii 96815
Website: www.hawaii.gov/tourism

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February 28, 2003

RECEIVED
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OFC. OF THE AUDITOR
STATE OF HAWAII

Ms. Marion M. Higa
State Auditor
Office of the Auditor
State of Hawaii
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917

Dear Ms. Higa:

Re: Response to Draft Report of the Financial Audit of the Department of Business, Economic Development and Tourism

In the draft report of the "Financial Audit of the Department of Business, Economic Development and Tourism," dated February 21, 2003, the Auditor determined that a reportable condition existed when the "Hawaii Tourism Authority has not adequately managed its contracts." The reportable condition was based solely on the finding that among all the contracts it has examined, "accounting for more than 70 percent of the authority's [fiscal year 2002] contract expenditures," it found a total of nine instances when (1) services were provided before a formal written contract was executed; or, (2) organizers of a festival or event submitted a final report to the Hawaii Tourism Authority ("HTA") either after the deadline provided in the contract, after the contract was renewed, or after final payment was made by the HTA.

Since the issuance of the Auditor's "Management Audit of the Hawaii Tourism Authority," Report No. 02-04, in February 2002, the HTA has sought to make great strides to manage its contracts in a manner that will achieve greater efficiency and accountability. Although HTA desires to achieve absolute contract compliance, it also recognizes there are extenuating circumstances that preclude strict compliance by a contractor and the HTA.

The Auditor found "three instances where contractors commenced work prior to the execution of legally binding contracts."

The large majority of HTA's contracts are not purchases of goods or services. Its contracts primarily provide funding for tourist related events that enhances the visitors' experiences in Hawaii. Many of these events are scheduled by necessity and are not governed by the initial legislative budget appropriation process or the subsequent HTA budget allocation process but must address specific strategic tourism initiatives and time periods. Therefore, total compliance could result in a festival or event not being funded because a contract could not be formally executed prior to its previously committed and established commencement date.

There are unique and extenuating circumstances that are faced by various festivals and events organizers that have also affected the HTA's desire to achieve absolute compliance with its own management and accountability goals. Many tourism related activities or programs are operated either as a small business, non-profit, or volunteer organization, with limited or no employees assigned to perform strictly administrative tasks. To place these types of restrictions on our constituency creates an undue hardship.

Initially, we note the HTA board has approved the award of the contract prior to the commencement of any service. The award was based on the description of services or events provided by the contractors. The general specifications, requirements, terms, and conditions that would be incorporated into any written contract were provided to the contractors during the request for proposal solicitation process. Both the contractors and the HTA were fully aware prior to the formal execution of the contract of the services and compensation to be provided. The services performed before the formal execution of the contract are also consistent with the description of services considered by the board when the contract was awarded.

Consequently, the HTA has sufficient and ample assurances that the services provided are those that would be described in a written contract. Based on these assurances, the HTA does not believe it would be exposed to the "jeopardy" of legal problems expressed by the Auditor.

Although proactive efforts were initiated to reduce the actual number of retroactive contracts, there are at times an unavoidable timing conflict between the award of a contract by the HTA board and the commencement of a tourism event with an established start date. Internal government processing and approval requirements (e.g., review, approval, and processing of formal contracts by the Governor's Office, the Department of Business, Economic Development, and Tourism, the Department of Budget and Finance, the Department of Accounting and General Services, and the Department of the Attorney General) also inhibit the timely execution of formal written contracts prior to the beginning of a festival, event, or tourism activity.

We note that the HTA has supported legislative measures to provide autonomy for the HTA from the various executive administrative procedures that impact its ability to promptly process the execution of its contracts. House Bill No. 225, H.D. 1, will provide HTA such autonomy and is currently being debated by the Legislature during this 2003 legislative session.

The Auditor also found "three instances" where the final reports were not timely received prior to the termination date of the contract, and "two instances" where the contract was renewed before a final report was received. A final report is a report prepared by the organizer of a tourism program or festival evaluating the program or festival after it has ended. The report is also used by HTA as an evaluation tool when considering future requests for funding. The submission of a final report is not an integral and substantive part of the tourism program or festival that the HTA has funded.

In a contract, the termination date is provided and it is the date the parties have agreed to complete performance of the festival or event with the addition of a reasonable time to prepare a final report. There are occasions, however, when contractors may not timely submit a final report. In such an occasion, the HTA would work with a contractor, on a partnership basis, to comply with the contract terms and conditions.

Moreover, contracts for tourism projects are not renewed without an internal assessment of the previously conducted project. Independent staff observation and monitoring of the activities of the various tourism projects were performed during the previous period of actual performance. HTA's past evaluations of the same project also provided sufficient and reasonable basis for the HTA to renew the contract prior to the receipt of a written final report from the contractor.

In lieu of finding the contractor to be in breach of the contract and not give the contractor its final payment, the HTA has chosen to exercise its discretion to waive the technical non-conformance. The HTA would work with the contractor to ensure prompt compliance under the unique circumstances presented for not timely submitting the final report. In every instance, the HTA is aware of the non-conformance and would seek to manage the contract on a partnership basis.

Finally, the Auditor found "one instance" where the HTA "dated" a contractor's payment prior to receiving a final report. Upon research of this instance, the only situation that may be applicable was when the HTA caused a check to be issued but withheld presentation of the check to the contractor until receipt and approval of the final report. The withholding of the check was an effective means of managing the contract.

The HTA is abundantly aware of the strict and close scrutiny provided by the Auditor, the Legislature, and the public over its contract management and accountability of public funds. However, the HTA is also cognizant of its delegated statutory duty and responsibility to implement state policies and directions for tourism, especially when tourism remains the primary economic resource for the state during this period of economic instability. Its current management of contracts was tempered with the need to develop a working partnership with businesses in the private sector to jointly achieve the public benefit of promoting tourism in Hawaii through the enhancement of emerging tourism activities. Our current relationship with the various tourism project managers have also been based on a working partnership to provide the most efficient process to promote and market tourism for the benefit of the entire state.

However, because of the Auditor's finding of a reportable condition, the HTA will immediately serve notice upon all its contractors that the HTA will now insist upon strict compliance to its technical contract management requirements. Although this measure is draconian, we will need to address the Auditor's concern. Alternatively, we will continue to support legislative efforts for executive autonomy as one means of addressing the untimely execution of contracts. It is also assumed that the HTA would address all internal management practices to ensure the prompt drafting of contracts and to seek the timely receipt of final reports.

To the extent it has always been HTA's desire to achieve a level of credibility when exercising its proper discretion to manage its contracts efficiently and in a manner consistent with its delegated statutory responsibilities, the HTA has no objection to the Auditor's recommendations and will immediately serve notice upon all its contractors that the HTA will demand strict compliance to its contract management requirements.

Very truly yours,

Rex D. Johnson
President and CEO